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Finance and Its Reform

Beyond Laissez-Faire

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and
Lawrence H. Summers

Many economies would benefit from less government intervention in financial markets, but the prescription should not be abrupt or total government withdrawal from the financial sector. Rather than intervening heavily in credit allocation decisions, governments should focus on doing what only they can do: providing an enabling environment for the private financial and nonfinancial sectors, and ensuring that financial operations are safe and sound.

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This paper — a product of the Financial Sector Development Department — is part of a larger effort in the department to study the role of finance in development. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Paulina Sintim-Aboagye, room N9-059, extension 38526 (August 1993, 24 pages).

That the financial sector should be liberalized was the orthodox view in the mid-1970s, during a pendulum swing toward reliance on the free market. In the early 1980s, the pendulum swung back to the left, based partly on evidence — especially from Latin America — that overly rapid reform had real costs, and partly on an increased appreciation of financial market failure. Blind adherence to free market principles was no longer appropriate. Now a counter-counterrevolution is in sight, with some swing back toward the view that the market makes a mess of it, but the government makes it even worse.

Caprio and Summers agree that market-oriented financial systems appear to do a better job than systems with extensive government involvement, but contend that the assumption that perfect competition will solve all problems in finance — especially in banking — can be dangerous. Information problems, implicit or explicit government guarantees associated with deposits, and externalities associated with the payments system make banks unique.

Governments implicitly recognize banking's uniqueness — few allow just anyone to enter banking — but public pronouncements and observers' recommendations often favor a move to more competition. Perfect competition, however, is optimal under the assumption, among others, of no government guarantee. In fact, most governments differ only in how explicit they are about their deposit insurance schemes.

The financial reforms most likely to succeed are those that give banks an incentive to engage in safe and sound banking. When excessive competition is allowed, the "charter value" of banking diminishes to the point that it is no longer profitable for bankers to behave prudently.

A consideration of finance's role, and a look at how reforming economies have fared, suggest also that gradual reform is often to be preferred in this domain. Deregulation of credit markets and interest rates can be counterproductive in unstable macroeconomic conditions and when banks are unsophisticated or have weak balance sheets. And changes in the charter value may evolve only slowly after reform.

Faster progress and greater efforts should be made, however, in bank supervision and regulation and in institutional development, including accounting, auditing, legal and judicial reform, and training (of bankers and other finance professionals).

In sum, many economies would benefit from less government intervention in financial markets, but the prescription should not be abrupt or total government withdrawal from the financial sector. Rather than intervening heavily in credit allocation decisions, governments should focus on doing what only they can do: providing an enabling environment for the private financial and nonfinancial sectors, and ensuring that financial operations are safe and sound.

Finance and Its Reform: Beyond Laissez-Faire

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Introduction

The reform of financial systems is an area of economics which has seen broad swings in economic thought. For much of this century, with notable exceptions such as Schumpeter, orthodox thought was that money and finance did not matter or were not all that important in the development process. However, by the mid-1970's, the orthodoxy held that financial repression had to be stopped at all costs, and this liberalization in the financial sector led the way for the more general acceptance of the view that reliance on the free market should be complete. Likewise, in the early 1980s the pendulum swung back to the left in the approach to financial systems a bit earlier than it did in other areas of the economics. Based partially on evidence, especially from Latin America, that overly rapid reform had real costs, and partially on an increased appreciation of market failure in finance, it was accepted in the financial sector that blind adherence to free market principles was not quite appropriate.[1] And a counter-counter revolution is in sight, with some swing back towards the view that the market makes a mess of it but the government makes it even worse.

The status of this debate is of direct relevance for developing countries and transitional socialist economies (TSEs), where financial crises -- overt and hidden -- are rife and authorities are confronting basic decisions about the role of government in the financial sector.[2] Some policy makers and advisers in particular appear to be embracing "the market" without a clear appreciation of its limitations in the area of finance. Moreover, in addition to the well known episodes of bank failures in the United States in the 1980s (and ongoing concerns in the 1990s), other industrial country governments, including those from Scandinavia to Japan, are experiencing concerns about -- and large actual and potential losses in -- banking. Indeed, latest unofficial estimates place nonperforming loans (NPLs) for the Japanese banking system at 42-58 trillion yen ($336-464 billion); if half of these NPLs result

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[1] Seminal articles are Akerlof (1970) and Stiglitz and Weiss (1981).

[2] See World Bank (1989) for a description of financial distress in developing countries, and Caprio and Levine (1992) on the task of financial reform in TSEs.

in losses, the cost would be roughly equal to estimates of actual losses the S&L debacle ($150 to 225 billion) in the United States and a fortiori would represent a larger fraction of GNP.[3]

Developing countries also offer lessons on financial reform for other countries. In some, banking systems that were restructured just a few years ago are in difficulty again. And in several developing countries, as in the industrialized world, banking systems liberalized with little attention to their initial conditions encountered subsequent financial distress. Given the generality of financial sector crises, then, it is opportune to reflect on how finance functions and on what should be the government's role in the process.

This brief paper presents a few thoughts on finance that are relevant for policy makers regardless of their position concerning government's role in finance. The next section reviews some recent empirical evidence that lends support to the belief that market-oriented financial systems function better than those with heavy government intervention. But no study shows that the best intervention is no intervention, nor that the optimal rate of adjustment to a state of less intervention is instantaneous. Section 2 argues that, because of implicit or explicit government guarantees, coupled with externalities generated by the payments system, the financial system -- and in particular, those institutions called banks -- are special. We suggest that, unless a convincing way can be found to remove these guarantees, bank management must resume its role as the main line of defence against unsafe and unsound banking, not least because of the difficulties inherent in external bank supervision. Therefore, incentives (influenced by the value of bank charters) should be increased to encourage management to reassume this role. Section 3 notes that there may be case for speed limits regarding some aspects of financial sector reform, and section 4 treats special problems where financial systems are either rudimentary -- as in the very low income

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[3] Cargill and Mayer (1992) provide present value estimates of the insolvency and thrift bailout costs for U.S. S&Ls, which represent as much as 4% of GDP in 1991. See Oxford Analytica (June 4, 1992) for a discussion of official and unofficial estimates of nonperforming bank loans in Japan. The larger figure cited in the text for NPLs would be about 14% of last year's GDP, and so the assumption in the text (that half of NPLs become actual losses) would put a "guesstimate" of potential losses at 7% of GDP.

countries -- or virtually nonexistent, as in the TSEs. Both situations call for a creative role for government, focussing on what governments' can do best, and not expecting that the market can solve all problems satisfactorily.

We should note that prescriptions to increase the safety and soundness of financial systems should be offered with some modesty, as it is difficult to select any country that has succeeded. Our preferred solution,[4] which relies on increasing the franchise value of bank licenses, means less competition and perhaps less innovation, so the gains from safety and soundness must be weighed against possible losses in terms of a narrower menu of assets or poorer service. Authorities in each country must weigh these factors against the costs of inaction, or of some other way of lessening the riskiness inherent in many banking systems today. And careful analysis of any changes to financial system regulation is important, especially as it takes some time for changes in the rules of the game to affect the internal incentive systems within financial institutions.

1. Is It Real?

A first question, given the disparate views on its significance, concerns whether or not finance matters. To some, financial markets are chaotic casinos, whereas many economists regard it as dogma that a more efficient financial system insures a more efficient allocation of resources, funneling capital from low to high value projects. Is there any evidence that this is actually the case? The first type of such evidence shows that financial development yields more growth. By itself this evidence is unconvincing because any notion of how financial deepening operates could be expected to go along with growth. And it would not be implausible if a more sophisticated financial system developed in anticipation of future growth. So the attempt of this explanation to disentangle causality from timing evidence

[4] It is useful to add that there is little consensus on reform strategies in this area, and that our proposed solution is not a policy of the World Bank or its Board.

seems to be inherently limited.[5] A more interesting attempt by King and Levine (1992) finds that, in a broad cross sectional study, countries with a greater proportion of credit intermediated by commercial banks (in contrast especially to central banks in countries with large directed credit programs) grow faster, as do those with a greater share of credit being extended to the private sector. Moreover, this study finds significant links between bank intermediated credit, credit to the private sector, and economy-wide measures of efficiency. Perhaps most interesting of all, it finds that financial sector development had a more robust link to growth than did other policies.

Although this cross-section approach finds some relationship between the development of the financial sector and growth, it does not show that complete laissez faire is necessary to achieve adequate financial sector development. Indeed, as shown in Figure 1, King and Levine find evidence from a cross section of 90 countries over the 1974-89 period that only severe interest rate repression has a significant impact on growth (where countries are grouped on the horizontal axis in terms of their relative growth rates). This evidence is consistent with a study by Gelb (1989), which found that although interest rates and growth are positively associated, most of the relationship relates to reverse causation -- higher growth raising efficiency and then interest rates. Direct causation from interest rates to growth was thought to represent more efficient intermediation of funds by the formal financial sector. Also, Reynoso (1989) presented some evidence suggesting that the relationship between saving and real interest rates may be an inverted parabola, with saving increasing most significantly when rates rise from sharply negative rates to near zero.

Thus empirical evidence appears to be consistent with a policy of ending severe interest rate repression but with still maintaining some control of or intervention regarding rates, on the condition that no more than mild repression is allowed. In other words, while severe repression is disastrous for financial intermediation and economic growth, slight

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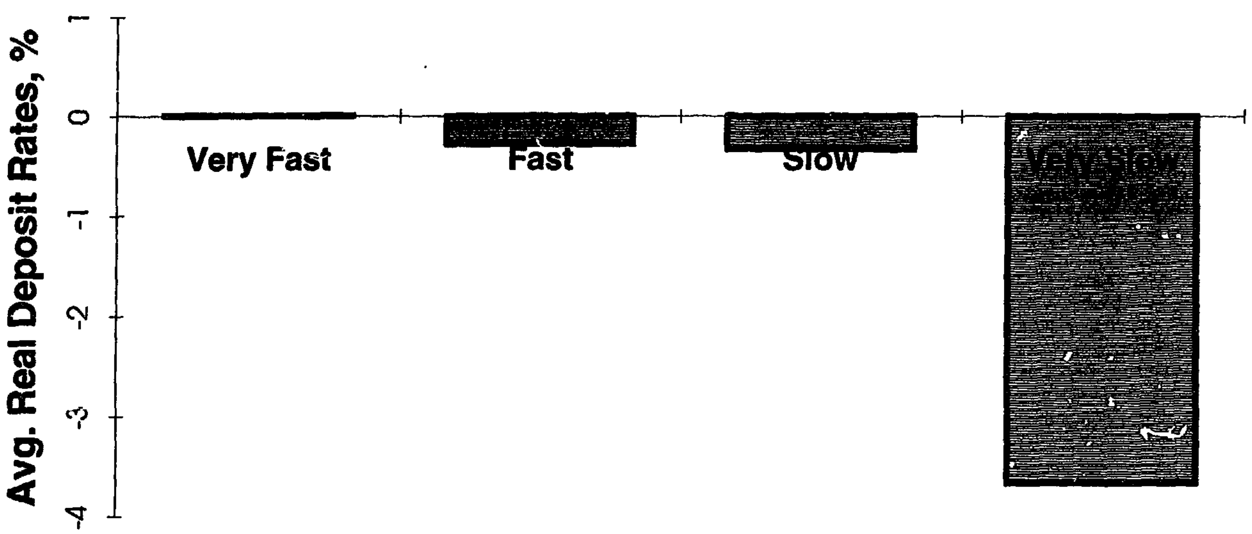
5 Jung (1986) tries to disentangle whether finance causes growth (in the sense of Granger) or vice versa, and finds not surprisingly that the causality goes both ways.

Figure 1
Interest Rates and Growth: 1974-89



Source: King and Levine (1992)

repression may be preferred to very high real rates, especially when the latter results from competition between banks with negative net worth. For example, Stiglitz (1993) has suggested on several occasions that demand deposit rates be limited to no more than treasury bill rates, especially where the latter are market determined. This link would indirectly reduce (wasteful) competition among banks for funds to make high risk loans in the hopes of restoring their net worth to positive levels, as occurred in the U.S. S&L crisis. Where rates are administered, this rule would serve as a useful yardstick for officials.

Another type of evidence for the importance of finance looks at changes in flows of credit following the onset of financial reforms, in particular those that give banks greater discretion over their lending and interest rate decisions. In Ecuador and Indonesia, Schiantarelli et al (1992) show that credit flows changed significantly following the onset of financial reforms, with evidence that credit flowed to more efficient firms in both cases, even after adjusting for variables such as the age, size, and export orientation of firms.[6] Moreover, in Indonesia there was a significant lessening of the extent to which small firms were credit constrained in their investment decisions following the 1983/88 reforms. These micro level efficiency gains were matched by increases in (some) economy-wide measures of the incremental output-capital ratio (IOCR).[7] Efficiency gains appear less clear cut in Korea, both in the firm level data and in the IOCRs. Small firms there also became less credit constrained by the end of the 1980s, but this is likely the result of a deliberate government policy rather than from a reduction in the government's role in the credit allocation process. Again, however, where clear signs of efficiency gains were found (Indonesia and Ecuador),

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[6] That efficiency gains are possible is plausible. Even in the United States the magnitude of market imperfections that exist is impressive. Somehow the rich appear to have different investment opportunities than those that economists discuss; they scoff at either the five percent return available on Treasury bills or the eight percent adjusted real return available historically on stocks. Instead, these investors looking at yields in all sorts of sectors do not look at those with less than a 20 percent expected return. And many Wall Street houses make substantial profits on arbitrage opportunities. One would assume that unarbitraged profit opportunities are present to a much greater extent in less developed countries. In a microeconomic sense, therefore, liberalization can make a significant contribution to growth.

[7] Over a short period of time the IOCR is an unreliable guide to efficiency, and often is quite sensitive to how investment data are deflated.

they were associated with a decrease in -- not an elimination of -- government intervention. So while the combination of cross-section and country specific evidence linking less-repressed financial regimes to increased efficiency is convincing, it by no means argues for an end to all interventions, but rather signals an appropriate direction for many countries.

2. Competition in Finance

Is too much competition possible in finance? Leaving aside the problem of transition, would the optimum optimorum be a freely and fully competitive banking system in which the financial services had the character of perfect competition as idealized in economics textbooks? Several reasons have been offered for being skeptical of that goal. First, the significant externalities related to information issues in finance all point to problems if the market is left on its own devices. Second, some aspects of finance might be welfare-neutral or even welfare-reducing, as when productive activities are interrupted for the purpose of speeding up the clearing of financial markets.[8]

But perhaps the most important reason for being skeptical of a free market as the standard in finance, is what can be called the deposit insurance conundrum. Many countries have explicit deposit insurance; many countries do not. But in no country is it convincing that the government would be willing to let large financial institutions collapse without taking some kind of action.[9] Indeed, U.S. authorities were not able to allow the Chrysler Motor Company to close, so it is difficult to believe that G.M., with its large financing company, or American Express, much less Citibank, would be permitted to fail. Also, U.S. monetary authorities injected a great deal of liquidity at the time of the 1987 stock market crash, with estimates up to $10 billion in the days immediately afterwards, and an even larger sum before it. It is argued that heavy moral suasion was applied to encourage banks to support brokerage

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[8] See Summers and Summers (1989) for an elaboration.

[9] The Argentine government currently is trying to convince its populace that it will let any bank fail, and has allowed some small provincial banks to close, with depositors taking a loss. However, this new policy has not yet been tested on a large bank.

houses, and it is noteworthy that although 58 houses closed in the month after the crash, no large brokerage firms went under.[10]

Many economists think that the case for deposit insurance is clear -- their grandmothers should have it but the rich should not. However, there are actually two reasons for having deposit insurance -- not only to protect the small saver but to insure the stability of the payments system by preventing rapid withdrawal of "hot" money. In the modern era, institutional funds can be withdrawn from a bank well before depositors can even queue up outside the bank's doors. The attempt to limit deposit insurance by concentrating on small savings alone, therefore, is not good strategy, as it only encourages large depositors to be more nervous or to spread their large sums into smaller accounts.

Some type of deposit insurance will need to be provided, but is this a function of the private sector or the government? The argument to let the market take care of it is, at least on the surface, persuasive. Without government-provided insurance, depositors would be more inclined to try to monitor their own institutions, and banks would be encouraged to form coinsurance groups or other coalitions, such as the clearing house system in several U.S. states in the 19th century.[11] However, notwithstanding the successes during this period, these systems encountered problems when banks were encouraged or compelled by legal limitations to concentrate their risks. Large numbers of geographically separated, undiversified banks are difficult for banks themselves -- or their supervisors -- to monitor.

To be sure, banks can be made safer and easier to monitor in many countries by allowing or encouraging them to diversify. The U.S. banking system has been more prone to crises and failures, compared with its Canadian counterpart, largely because of the U.S. ban on interstate branching, which only began to erode in the 1980s, but has yet to be abandoned. Thus Canadian supervisors have both fewer and more diversified institutions to monitor.

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[10] Garcia (1989) provides these data and a view of Fed policy at the time of the crash.

[11] See Calomiris (1992, 1993) and other references provided there.

Many developing countries' financial systems are more similar to that of the United States: their banks are undiversified due to a combination of small economic size and the concentrated structure of individual economies, in conjunction with capital controls which prevent banks from holding any significant proportion of assets overseas. Consequently, without an abandonment of controls on capital flows (which in many countries is conceived of as the last stage in the reform process) and an easing of branching restrictions among countries, many developing country banks will necessarily be riskier than their industrial country counterparts.

Authorities have to be concerned about making banks safer because ultimately they will be held accountable when (sufficiently large) banks fail. The counter-argument, that depositors can monitor banks effectively, is not convincing. Empirical studies of the stock market performance of U.S. banks in the 1980s find little evidence that stock prices were able to anticipate the downgrading of banks to problem status.[12] In some cases, the market appears to have gotten the direction of change generally right but the magnitude of price decline was not statistically significant. Moreover, for those banks that Simons and Cross found did experience stock price declines (12 of their sample for which the market at least got the direction of change right, even if statistically insignificant), little negative commentary was discovered in the financial press about these banks. But perhaps most damaging was their finding that insiders -- managers and directors -- were more often buying shares immediately before the downgrading![13] So there can be little credibility to the assumption that depositors will be able to monitor banks effectively. Governments will therefore be impelled to provide explicit or implicit deposit insurance; even a government which wanted to renounce this role could not, given that so many other governments are providing this insurance.

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[12] See Simons and Cross (1991).

[13] A Machiavellian cynic might say that the evidence on insiders probably reflects deliberate buying high to cover their tracks for still larger sales further in advance of the bank's demise.

What does this mean? The basic economics invoked here are clear enough -- a bank with few assets has a strong incentive to take risks. These risks enable it to compete for deposits more effectively and if it does not win, it is the taxpayers who lose. Even banks that are not inclined to take advantage of deposit insurance will be encouraged to do so in order to compete for deposits. A few bad apples therefore create strong pressure toward involvement in risk taking by bidding away deposits. So bank failures likely will continue to be a part of the developing country financial landscape barring major changes. Supervision is one part of the solution to this problem; any part of the world without supervision proves that this is true. But supervision faces chronic problems in many countries, typically being starved of resources and subject to severe pay constraints. Moreover, both political and economic forces lean towards supervisors keeping silent about problem banks until net worth is already negative. And the above evidence on stock market anticipations of bank failures also does not give solace to those who believe that supervisors will be able to serve as the main defence against failure. So while better supervision is needed in many countries -- both developed and developing -- we argue that it is unrealistic to expect government supervision to be the main line of defence.

A second solution is often dubbed "narrow banking," meaning that banks can be made safe by being required to invest solely in short-term riskless securities, such as treasury bills. Only safe banks would be "backed" by the government, while all other financial institutions could offer a variety of financial products -- even, perhaps, demandable, fixed-rate deposits -- but would not be allowed to call themselves banks and would not be eligible for government guarantees.[14] Proponents of this solution point to the success of money market mutual funds and assume that narrow banks will behave similarly, while critics say that there is insufficient supply of riskless assets (T-bills) to back the potential demand for riskless deposits. But both views neglect changes in the price of riskless assets; in particular, these prices will rise in a narrow banking world if society values such assets so highly. This will occur to the delight

[14] This recommendation dates back to Simons (1948), in the best Chicago tradition, and is closely related to the recommendation for only allowing Islamic banks, which are in theory checkable money market funds. See Litan (1987) for an updated view.

of government debt offices but will also lead narrow banks -- and the less supervised nonbanks -- to want to hold some less secure paper.[15] Indeed, one possible result would be that nonbanks would offer deposit accounts backed by higher yielding assets, which could be subject to default. Thus, while this solution has much to recommend it, authorities may be reluctant to try an untested model, and it will only prove effective if nonbanks, regardless of size, are allowed to fail.

Another possibility is to raise capital requirements to high levels, but the difficulty is first, that it is hard to get international agreement on capital requirements and second, -- and relatedly -- that capital requirements appropriate for small, low income countries may be inappropriate for more diversified, higher income neighbors. Yet, if one country were to raise capital requirements above that of others -- without a commensurate increase in expected profits -- then that country's banking system would move offshore.[16]

A better solution to the deposit insurance conundrum relates to bank profitability and capital. Successful banking institutions require some cushion of profitability and capital, a cushion that could be driven out by turning the financial industry into one characterized by wide-open entry. As is true for nuclear power plants, free entry is not sensible in banking, as unfavorable chain reactions -- bank runs -- are possible, and the adverse fallout can be severe, in terms of the damage done when payments systems are destroyed and barter returns.[17] One of the reasons why the United States had a financial crisis in the 1980's, rather than in the 1950's, is not entirely macroeconomic, as the 1950s was a decade marked by recessions and

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[15] With the decline of interest rates in the United States in 1991-3, there has been a move away from CDs and safer instruments in search of higher yields -- even the junk bond market has enjoyed a resurgence. A move to narrow banking could reinforce this switch.

[16] It might be argued that offering deposit insurance would tend to raise franchise value and thereby limit the offshore movement of domestic banks. However, this effect is only true *ceteris paribus*, and can be easily lessened by giving out too many bank licenses.

[17] And supervising banking may be as difficult as regulating nuclear power plant: at least -- or at least insofar as scientists are aware -- nuclear particles do not have an incentive to misrepresent themselves to regulators!

sluggish growth. At least in part, it is that over time, technological change and regulatory arbitrage led to reductions in barriers to entry in the deposit taking and lending business, eroding bank profits and forcing banks to accept or vigorously solicit riskier business. In other words, the franchise value of a bank license was sharply reduced. When that franchise value was eroded, bankers stood to lose less by going bankrupt; with no franchise value there was no reputation to protect and no reason to avoid going bankrupt. And the S&L problem was worse than that in the commercial banking sector largely because more severe restrictions on asset and liability choices of the former group led to a greater erosion of franchise value; a government guarantee coupled with low franchise value can be expected to attract all sorts of gamblers to an industry.[18]

So a solution to this conundrum should include some way by which the franchise value of bank licenses is enhanced. Entry limits are one way: authorities should be prepared to restrict entry in order to allow higher bank profits and a build up of capital, in this way leading to an excess demand for bank licenses. Indeed, as Calomiris (1992a) has described, it was by restricting entry and allowing for accumulations of profits (bank charter value) that American banks grew and promoted economic development in the early 1800s. When bank licenses have a significant value, bank management will be more likely to set up internal controls and oversight systems that will help to preserve their franchise. Then bank managers will be the first line of defence, with supervisors there to assist, working with managers, in ferreting out unsafe and unsound banking practices. Supervisors will of course be needed to assure that required capital and needed provisions actually are there, especially since even with a high franchise value, some entrepreneurs with very short-term horizons could still be attracted to banking; a bank license in the wrong hands could indeed become a license to steal. Note that this solution has some similarities with that of raising capital requirements, in that owners would have a larger present investment or expected future profits at stake, either of which would encourage safe and sound banking. Also, higher capital requirements would

[18] Weisbrod, Lee, and Rojas-Suarez (1992) argue that the franchise value of bank licenses has declined in the United States and Japan.

drive banks out of existence and would result in a higher spread between borrowing and lending interest rates.[19] But the franchise value solution does not rely on getting international agreement. Rather than driving banking offshore, greater franchise value would create an excess demand for bank licenses in the country where a bank franchise is truly valuable. Depositors might try to move abroad if insufficient competition led to low deposit rates, but bankers will quickly deduce that deposits are more mobile than loans, given information problems, and price their products accordingly.

In the United States some may argue that this solution is not feasible: nonbanks have already "won over" the better risks (blue chip clients), and financial sector firms can get around any barriers set up to make banking more profitable. However, this view neglects the use of regulations in the United to reduce the franchise value of bank licenses, in particular by limiting interstate branching. A complete end to these barriers would lead to rapid consolidation of U.S. banking and likely boost the value of surviving banks. Truly national banks -- certainly fewer than the 12000-13000 at present -- would be well-placed to compete with nonbanks, especially if the current drive to widen the ability of banks to engage in securities-related business continues to be expanded. With stronger, national banks, there is little reason to believe that the U.S. bank failure rate would differ significantly from the far lower rate in Canada or Germany.[20]

In developing countries and TSEs, financial engineering is far less advanced, and bank

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[19] With higher capital levels, banks would need larger interest spreads to show the same return on equity, *ceteris paribus*. So in moving from lower to higher capital requirements, one would expect to see exit from banking until the risk-adjusted return attained its previous alignment with that in other industries.

[20] It must be emphasized that reliance on this solution will only work within limits: if entry is restricted so tightly that substantial monopoly profits appear, nonbanks be attempt even more to offer products similar to those offered by banks. But within limits we think that it is feasible to have profitable banks and nonbanks operating side-by-side. Securitized finance or the issuance of paper directly to investors has enjoyed several booms (the 1920 and the 1980s most notably) but usually retrenches during the contractionary phases as investors are reminded of the risks they face. Also, investors confronted with the choice of bank deposits, bills, bonds, and stocks, often choose to diversify among all of the above instruments. If nonbanks encroach sufficiently on banking, authorities will be faced with either extending guarantees to these activities or allowing banks into new forms of finance.

supervision skills are far less developed. Thus keeping entry limited and thereby promoting the franchise value of bank licenses may be the best hope of fostering the spread of safe and sound banking to these countries. But paying attention to franchise value (or bank capital) alone will be insufficient in small, highly specialized economies, as the franchise value (or capital requirements) of banks needed to ensure safe and sound banking might be quite high. In these cases authorities will need to encourage safe international diversification of banks as well. Indeed, one could envisage a menu of choices on entry and portfolio limits. When confronted with the choice between allowing pockets of wealth to accumulate at home or permitting the investment of domestic savings abroad, eventually politicians may converge more to the former solution.[21] Authorities will then have to struggle with the tradeoff between too little competition and innovation and potentially unsafe banking practices.

3. Constraints on Reform: possible speed limits

Should that deregulation which is desirable happen as quickly as possible? The above qualifications notwithstanding, the direction that is appropriate in most countries of the world is clear. Many countries have excessive and/or inappropriate financial sector regulations that are aimed at meeting a variety of goals, such as that of providing cheap credit to the government and to preferred sectors or individuals. Yet contrary to simple minded economics, it seems that for both macroeconomic and microeconomic reasons one should move forward with some caution. First, some of the seeming successes, Malaysia and Korea, moved quite gradually in their reform efforts, in part because they enjoyed the luxury of

[21] Just as local U.S. banks often ended up financing money-losing ventures when they ventured outside their markets, and industrial country banks lost sizeable amounts in foreign markets, developing country banks also could lose money by investing abroad. But they could as well invest in global mutual funds and thereby enjoy a stable return uncorrelated with that in their own market. In this sense they would become less risky institutions. The main point is that in countries with 20% to 50% of GDP accounted for by one product, swings in the terms of trade will routinely wipe out all but the exceptionally well capitalized, or highly profitable, banks.

favorable macro circumstances.[22] Second, financial reforms affect incentives, and it likely takes some time for the ramifications of these changes to filter through to affect internal bank incentive systems. Banking systems that have been designed to respond to government directives will not instantaneously adjust to commercial methods even if injected with fresh capital and told that all restrictions are off. Third, financial repression, whatever its other aspects, is a way of collecting government revenue, directly when the banking system has to hold government bonds and indirectly when interference with their intermediation reduces interest rates and therefore makes it possible for government bonds to remain more attractive than they otherwise could.

One of the lessons that learned after a decade of experience with structural adjustment programs is that fiscal stability is essential to the broad consequences of reform and that it is often true that bad taxes are better than no taxes. Where the fiscal situation is difficult, it is appropriate to undertake reform more gradually than would otherwise be done. Just as there is a dynamic within the government whereby many are worried about the budget deficit but more concerned about their favorite government program, there are similar tendencies among many economists who specialize in certain sectors. Financial specialists want financial repression reduced or eliminated; trade oriented economists want tariffs reduced; human resource experts want more total spending; and infrastructure advisers want more infrastructure. So in the end, nobody is left to focus on the problem of the budget deficit. This orientation is understandable: after all, governments are not known for achieving budgetary savings in the absence of strong pressures, and sector specialists may respond by pressing for more than they reasonably hope to obtain. Bargaining strategies aside, the most sensible course of action would then appear to be to set out a reform program over a period of years, putting pressure on the budget but giving time for realistic budgetary realignments. In the context of financial reform, a government that is funding itself by the forced allocation of bonds to commercial banks might be weaned of this habit over a fixed time horizon.

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[22] And when macro circumstances seemed poor, Malaysian authorities put reform efforts on hold and reasserted control of interest rates until borrower (and bank) net worth improved (see Zainal. et al, 1992).

Another reason for gradualism in the financial sector is that reform in this area cannot prudently run too far ahead of those in the real sector. Abrupt reform, such as immediate interest rate deregulation or bank recapitalization, should be linked explicitly to real sector changes. Complete interest rate deregulation is unwise when basic macro stability is wanting, as the danger of high and fluctuating rates can impair the stability of otherwise viable firms.[23] As Stiglitz notes, if the government is guaranteeing deposits, then it is difficult to justify deposit rates above the riskless rate on short-term T-bills. Bank recapitalization, another "sexy" step in financial reform, is often wasteful where steps are not taken to assure that good money will not be thrown after bad. These steps not only can be expected to entail replacing bank management and installing an effective incentive system and risk evaluation and control processes, but also in many cases ensuring that factors external to the bank are corrected as well. This may mean removing legal restrictions that limit portfolio diversification or, as in many TSEs, restructuring enterprises.

It should be clear, however, that the case for gradualism does not mean inaction. Governments can move rapidly to eliminate the grossest form of credit subsidies and restore interest rates to levels at least close to inflation rates. In fact, Malaysian authorities removed much of the subsidy element for directed credit early in the reform process. Many financial sector reforms are long gestating, can be started at little cost immediately, and are sine qua nons for private sector development. Training of commercial and central bankers, creation or upgrading of accounting and auditing standards (and professions), and legal and judicial reform all help financial markets function by improving methods for contract monitoring and enforcement and will speed the development of markets. In most of these areas there are significant externalities, so that without government involvement less investment will be forthcoming; foreign assistance and expertise also can help to speed up the process, either by providing advisory services or funds conditional on the achievement of certain reforms, especially those where domestic interests are a barrier.

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[23] Gertler and Rose (1992) make this point clearly. See also Caprio, Atiyas, and Hanson (1994) for additional preconditions for successful interest rate deregulation.

4. Special cases?

At least two areas stand out where there appears to be a special case for "extra-market" action. The first set concerns bank regulation and the role for government intervention in the poorest economies, those classified as low income developing countries. The above discussion of franchise value is particularly relevant here: if many industrial countries, including Japan and the United States, have difficulties in managing a banking system, the problems in this area must be very real. In very poor countries, the ability to supervise financial institutions will be even more limited than in the industrial world, and risks may be more pronounced, especially if the country's productive structure is relatively undiversified and capital controls limit diversification. And without substantial foreign assistance, there usually is only quite limited bank supervision. In this environment, allowing the market to create its own financial institutions through free entry entails great risk. Instead governments can intervene and restrict the supply of bank licenses and attempt to ensure that only reputable persons enter into banking. The creation of monopoly rents will both encourage the internal control over banking, without which it will self destruct, and also stimulate the creation of pockets of wealth which can be used to advance real sector development.[24] Indeed, some small, low income countries already have just a few banks that make high pre-tax profits, but then the government taxes them away, so the banks have little franchise value to preserve.

An even greater difficulty for poor countries concerns government intervention in pricing and allocating credit and in encouraging the spread of the banking habit, especially to rural areas, where the cost of delivering banking services is high. As several authors have noted, the grounds for intervention often are unclear, and the record in many countries

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[24] Governments could license a few foreign banks and depend on the concern for the bank's own reputation to encourage them to monitor themselves and to bear the costs of imprudent lending. It is argued that Uruguayan authorities have relied successfully on this effect.

inspires little confidence.[25] For both the industrial and agricultural sectors, the scarcity of medium and long term finance in many low income countries is not disputed, but the popular solutions -- set up an institution that will only intermediate medium and long term funds or require existing banks to lend long some part of their resources -- have routinely failed. These solutions are based on the notion that such finance is not provided because of information imperfections. Unless public sector banks are better at collecting funds or borrowers more prone to pay back when loans are subsidized -- in both cases usually far from the truth -- neither the information asymmetries nor enforcement problems can be corrected by these direct interventions. Thus, Calomiris, Hubbard and Stock (1986) find that defaults on U.S. government credit in agriculture were double those on private loans, while forced term lending regularly is cited as a factor behind a retrenchment in intermediation.

Rather than information problems, other culprits -- macro instability and government failure to honor its own commitments -- often appear when term finance is moribund. Also, where the legal system reduces to creditors the value of collateral, short-term contracts are a way of maintaining control over borrowers, as noted by Gertler and Rose (1992). Judicial and legal reform, clarifying property rights, and possibly subsidizing the development of information capital are areas in which governments could better contribute to alleviating the shortage of term finance. The former areas would help improve the returns to intermediation once banks and other financial firms had established themselves, while the latter would contribute to a reduction in the fixed costs of establishing a financial institution.[26] Even a postponing of tax liabilities, perhaps by allowing little or no taxation (or an investment tax credit) during the initial years of a firm's life, could help improve borrower net worth and thereby increase access to credit. Once initial banking relationships are established (after perhaps 2 years or so), this form of subsidy could be ended. But this is a last resort

[25] See Besley (1992) and Calomiris (1992) for a review of the arguments for intervention.

[26] The subsidy could be paid to both banks and borrowers, in effect buying down the interest rate on initial loans for new borrowers, but of course would have to take account of budget pressures, as noted above. Caprio (1992) and Gertler-Rose (1992) make this argument. Calomiris (1992) notes the importance of fixed costs in setting up banks in rural areas, but the argument holds wherever information is scarce.

intervention, as it may lead to abuses and could prove unnecessary. Banks and informal lenders have shown themselves to be willing to invest in acquiring information where they can exploit the profits to be made from lending (Aleem, 1990). Term finance can also be encouraged by fostering the development of short-term money markets, whereby governments, usually through their central banks, can encourage the development of the trading skills necessary to the growth of longer term markets.[27]

In rural areas, the spread of the banking habit and the encouragement of finance to agriculture also has been an especially popular area of government involvement. As Akerlof (1970) and Calomiris (1992) note, agriculture is particularly fragile because of the concentration of risk and high fixed costs of establishing financial intermediaries in rural areas. As with lending to small and medium enterprises, governments have little direct ability to solve information problems, but may be able to intervene if high costs are keeping out financial institutions. Often, these high costs result from unclear property rights or other barriers to land sales, so governments can help especially by improving the enabling environment in these areas, as is relevant not only in low income developing economies but in reforming socialist states (Calomiris, 1992). Where lending is restricted because of monitoring problems, increased reliance on peer monitoring may well prove fruitful, as in the case of Grameen Bank (Stiglitz, 1990). Since society at large benefits from the spread of the financial sector, some subsidization of these institutions appears warranted.

Unfortunately, governments often see greater benefits than appear to exist both from directing credit and from encouraging the spread of banking, and especially tend to pass of the costs to the commercial banks. They also get excessively involved in the credit process, leading commercial banks to cease to assess credit risk or monitor the loans, as the risk is viewed as ultimately born by the government. And ruling that banks must have a certain number of branches in rural areas or grant credit on preferred terms is costless to authorities in the short run, which is why they tend to do too much of what appears to be a socially

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[27] Meek (1991) lucidly explains this point in the cases of Malaysia and Indonesia.

beneficial act. In the process, bank franchise value is eroded and the banks ultimately respond to this new, and perverse, incentive environment. Thus the challenge for governments is to keep interventions modest and not force the financial institutions to absorb the costs. For directed credit schemes, keeping programs relatively small and broad-based, like those in Malaysia, which also allowed banks to cover their average cost of funds plus a generous markup, appears to offer the best chance of succeeding both in directing credit to targeted groups and in avoiding large losses. The absence of a large subsidy element in particular figured prominently in explaining the success of the Malaysian.[28] Interestingly, Japan's reliance on directed credit was much less than many have thought, with only about 10% of total credit accounted for by "policy-based" loans [JDB, 1993]. And any subsidy was quite small, first because real interest rates were maintained in the neighborhood of zero and second, and more importantly, because effective monitoring and control systems ensured a virtually 100% repayment record, many times the rate in some developing countries today.

Other actions to help producers hedge risks, such as by fostering commodity futures markets or allowing residents to hedge in international commodity futures markets, would also contribute to the development and soundness of domestic credit markets. Where borrowers are unable to hedge themselves, specialized agriculture banks that have been encouraged by many governments concentrate risk further, which may account for the poor results seen in these institutions during the 1980s, when many commodity prices were weak. If government authorities wish to encourage rural finance, they should prefer to sponsor diversified institutions -- recognizing the diversity of rural economic activities in most developing countries, as well as the need for loan diversification in financial institutions -- and promote the use of hedging devices.

What of the special problems of transitional socialist economies (TSEs)? In some sense they are like low income countries in having undeveloped accounting and enforcement systems, with poor or "noisy" information channels. However, the problems of pre-existing

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[28] More subsidized credit was available directly from the budget. See Zainal et al (1992).

loan losses are much more formidable. TSEs also make no pretense about having either skilled bank supervisors or skilled bankers. Since these economies will have to function for some time with virtually no bank supervision and will be in environments fraught with risk, a radical solution -- endowing bank licenses with a high franchise value, legislating quite high capital adequacy requirements, or moving to a narrow banking system -- offers the best chance of successful reform. The polar extreme -- completely free banking -- makes sense only when the government is prepared to allow depositors of all institutions bear losses; otherwise, "free" banking will be expensive for the budget. Since government resolve often weakens when losses get large, this extreme solution is dangerous.

Another extreme is to ban all debt since the environment is so risky (McKinnon, 1991). This solution pays too little attention to the need to finance the new private sector and neglects the point here that banking can be made safe when bankers have adequate incentive to police themselves. Our preferred solution, promoting franchise value, may be close to McKinnon's in practice: with initially only a few licenses being granted to competent bankers, in all likelihood there will be a relative scarcity of debt finance compared with a free banking model, as he is encouraging. We would argue, however, that more profitable banking would lead to a healthier and less expensive banking sector, once the costs of financial crises are considered, yet would still allow for some debt-based financing.

Financial institutions in TSEs are faced with the challenge of financing the emerging private sector while assisting with the restructuring and/or closing of state enterprises, often in an environment of unstable average and relative prices and fluctuating macro policies. An additional complication is that for most of the TSEs, the government presently owns much of the financial sector and cannot just walk away from the institutions.[29] One approach -- close down all public sector banks and hope that private banks arise -- will not be tolerated. Most countries instead will likely gravitate towards a combination of trying to reform existing state banks while encouraging entry, in particular from foreign banks or joint ventures.

[29] Caprio and Levine (1994) elaborate on this argument.

Even with entry, however, some government involvement is essential during the transition period. If all TSE banks were miraculously transformed into world class commercial institutions, they would likely stop lending to all but a handful of private clients because of the riskiness of the environment. So while it may be useful to allow banks on their own to grant loans only on a commercial basis to small state sector companies, no government -- certainly no banking system -- will long withstand the closure of a large portion of its industrial base. There is therefore no choice but to have credit decisions for large state enterprises made by a government body, either in conjunction with a state bank or through the budget. To ensure that this temporary solution does not become permanent, a limit on the proportion of total credit extended in such a non-commercial fashion could be established and then lowered over a period of years.[30] The government will likely become the caretaker of at least one institution to which many of the bad loans may be transferred, whether in a new fund or an existing bank. Since governments routinely are poor at collecting debts, any efforts in this direction should be contracted out to private firms.

Concluding thoughts

The common thread to this paper is the notion that while market-oriented financial systems demonstrably appear to do a better job than ones with extensive government involvement, the assumption that perfect competition will solve all problems in finance is dangerous. Finance is different from steel or autos because of the externalities associated with the payments system, the importance of information problems, and the implicit or explicit government guarantees associated with deposits. We have argued here that, while many governments need to reduce their intervention in the financial system, these differences imply that perfect laissez faire competition may well not be the ideal. While governments

[30] The government also is the owner of state enterprises, many of which are transforming themselves into financial intermediaries through the accumulation (involuntarily on the creditor side) of interfirm credits. In Romania and Russia, these arrears have reached 80% to 100% of GDP. As owner of the responsible firms, the government must limit these credits if inflation is to be controlled. Caprio and Levine (1994) elaborate on this problem.

should recognize this point -- few allow anyone to enter banking -- public pronouncements and the recommendations of many observers are usually to recommend a move to more competition. This view only makes sense under the assumption of no government guarantee, but in fact most governments do provide deposit guarantees, and only differ in the degree of explicitness of the scheme.

Informed views of what finance is about, combined with a look at how reforming economies have fared, also suggest that gradual reform is to be preferred. Deregulation of credit markets and interest rates is likely to be counterproductive as long as macro conditions are unstable and banks are both unsophisticated and have weak balance sheets. As has been clear in other settings, deregulating when banks are "bust" and bankers unskilled leads to gambling; the resulting losses and the increased volatility of financial markets can set back, rather than advance, the move to more market-oriented systems. However, faster progress can and should be attempted in the areas of institutional development, as noted above.

Governments that have a choice should not attempt to move from a severely repressed financial system to a lightly regulated one overnight. To be sure, some governments have little choice: TSEs are beginning a wide ranging reform process effectively with no financial system, and need to move quickly. Still, complete laissez faire would be disastrous there, as would attempting to move rapidly to the types of systems in force in industrialized economies today, where banks freely make their lending decisions largely apart from the political system. While some new private banks can be licensed to deal with the new private sector, the transformation of the existing state banks will require at least a 5-10 year commitment. Lastly, in all countries, governments must remained focussed on doing what they do best: providing an enabling environment for the private financial and nonfinancial sectors. While market failure clearly can exist, governments should be rationed in their ability to use this argument as a justification for intervention.

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